CMA US Notes: US GAAP vs. IFRS Differences and Business Combinations

Main Conceptual Difference

- **US GAAP**: Rules-based, emphasizing detailed, prescriptive guidance.
- **IFRS**: Principles-based, focusing on broader objectives and professional judgment, allowing flexibility in application.

Key Areas of Difference

The following areas are critical for the CMA US exam:

1. Inventory
2. Long-lived Assets
3. Impairment of Assets
4. Intangible Assets
5. Leases
6. Revenue and Expense Recognition

1. Inventory

- **US GAAP**:
  - Allows **LIFO** (Last-In, First-Out) for inventory valuation.
  - Inventory is valued at the **lower of cost or market** (market = replacement cost, constrained by net realizable value and its floor).
- **IFRS**:
  - **LIFO is not permitted**; only FIFO or weighted-average cost methods are allowed.
  - Inventory is valued at the **lower of cost or net realizable value** (NRV = estimated selling price less costs to complete and sell).
- **Impact**: Companies using LIFO under US GAAP may report higher costs of goods sold and lower inventory values during inflation, affecting comparability with IFRS.

2. Long-lived Assets

- **US GAAP**:
  - Depreciation is typically based on the **entire asset**, not individual components, unless components have significantly different useful lives.
  - **Revaluation** of fixed assets is **not permitted**; assets are carried at historical cost less accumulated depreciation.
- **IFRS**:
  - Requires **component depreciation** when parts of an asset have different useful lives or usage patterns (e.g., a building's structure vs. its HVAC system).
  - Allows **revaluation model** for fixed assets; if fair value is materially different from carrying amount, revalue to fair value.
    - Increases are credited to **Other Comprehensive Income (OCI)** and accumulated in equity as **Revaluation Surplus**.
    - Decreases are recognized in the income statement unless reversing a prior revaluation surplus.
- **Impact**: IFRS provides more flexibility for reflecting fair value but requires more judgment in componentization.

3. Impairment of Assets

- **US GAAP**:
  - Impairment testing for long-lived assets occurs when a **triggering event** suggests the carrying amount may not be recoverable.
  - **Two-step process**:
    1. Compare undiscounted future cash flows to carrying amount; if lower, an impairment exists.
    2. Impairment loss = Carrying amount - Fair value.
  - Impairment losses cannot be reversed for assets held for use.
- **IFRS**:
  - Impairment testing is required annually for certain assets (e.g., goodwill) or when there are **indicators of impairment**.
  - **One-step process**: Impairment loss = Carrying amount - Recoverable amount (higher of fair value less costs to sell or value in use).
  - **Reversal permitted** for non-goodwill assets if conditions improve, with gains recognized in the income statement (limited to the original carrying amount).
- **Impact**: IFRS allows reversals, increasing volatility in financial statements, while US GAAP's conservative approach prohibits reversals.

4. Intangible Assets

- **US GAAP**:
  - **Research and development (R&D)** costs are generally expensed as incurred, except for certain software development costs after technological feasibility.
  - **Goodwill** is not amortized but tested annually for impairment at the reporting unit level.
  - Revaluation of intangibles is **not permitted**.
- **IFRS**:
  - **Development costs** are capitalized if **technological and economic feasibility** is demonstrated (e.g., a viable product with expected future benefits).

- Research costs are still expensed.
- **Goodwill** is not amortized but tested annually for impairment at the cash-generating unit (CGU) level.
- **Revaluation model** is allowed for intangibles with an active market (rare in practice).

- **Impact**: IFRS allows capitalization of development costs, potentially increasing reported assets and profits compared to US GAAP.

5. Leases

- **US GAAP**:
  - Distinguishes between **finance leases** and **operating leases** for lessees based on specific criteria (e.g., transfer of ownership, lease term ≥75% of economic life).
  - Both lease types require recognizing a **right-of-use (ROU) asset** and **lease liability**, but:
    - Finance leases: Interest and amortization are recognized separately.
    - Operating leases: Single lease expense on a straight-line basis.
  - Exemptions for short-term leases (≤12 months).
- **IFRS**:
  - **No distinction** between finance and operating leases for lessees (under IFRS 16).
  - All leases (except short-term and low-value leases) are accounted for like US GAAP finance leases, with an ROU asset and lease liability recognized.
  - Interest and amortization are recognized separately for all leases.
- **Impact**: IFRS simplifies lessee accounting but may result in higher reported liabilities compared to US GAAP operating leases.

6. Revenue and Expense Recognition

- **US GAAP**:
  - Follows **ASC 606**, a five-step model for revenue recognition (identify contract, performance obligations, transaction price, allocate price, recognize revenue when obligations are satisfied).
  - Specific industry guidance exists (e.g., software, real estate).
  - Expense recognition follows the **matching principle**, with specific rules for certain costs (e.g., advertising expensed as incurred).
- **IFRS**:
  - Follows **IFRS 15**, which aligns closely with ASC 606, using the same five-step model.
  - Less industry-specific guidance, relying on principles-based application.
  - Expense recognition is principles-based, allowing more judgment (e.g., capitalization of certain costs if future benefits are expected).
- **Impact**: While revenue recognition is largely converged, IFRS's principles-based approach may lead to differences in expense recognition and interpretation.

Additional Notes

- **Convergence Efforts**: US GAAP and IFRS have converged in areas like revenue recognition and leases, but differences remain due to philosophical approaches (rules vs. principles).
- **Financial Statement Presentation**:
  - US GAAP has stricter presentation requirements (e.g., specific line items on the balance sheet).
  - IFRS allows more flexibility in format but requires disclosures for revaluations and impairments.
- **Disclosure Requirements**:
  - Both standards require extensive disclosures, but IFRS emphasizes qualitative explanations (e.g., assumptions for revaluations).
  - US GAAP focuses on quantitative details (e.g., detailed impairment calculations).

Business Combinations and Consolidations: Example Problem

Problem

Scenario: On January 1, 2025, Parent Co. acquires 100% of Sub Co. for $2,000,000 in cash. Sub Co.'s net assets have a fair value of $1,600,000, including an identifiable intangible asset (patent) valued at $300,000 with a 10-year useful life. Under US GAAP, the patent is amortized, and goodwill is tested for impairment. Under IFRS, development costs related to the patent ($50,000) were capitalized prior to acquisition, and the patent is eligible for revaluation. Calculate goodwill under both standards and prepare the consolidation entry under US GAAP. Assume the patent's fair value increases to $350,000 by December 31, 2025, under IFRS.

Solution:

1. **Goodwill Calculation**:
   - **US GAAP**:
     - Purchase price: $2,000,000
     - Fair value of net assets: $1,600,000
     - Goodwill = $2,000,000 - $1,600,000 = **$400,000**
   - **IFRS**:
     - Fair value of net assets includes $50,000 capitalized development costs, so total fair value = $1,600,000 + $50,000 = $1,650,000
     - Goodwill = $2,000,000 - $1,650,000 = **$350,000**
2. **Consolidation Journal Entry (US GAAP)**:

3. Dr Assets (excluding patent) 1,300,000
4. Dr Patent 300,000
5. Dr Goodwill 400,000
6. Cr Cash 2,000,000
    - **Amortization of Patent (US GAAP)**:
        - Annual amortization = $300,000 ÷ 10 years = $30,000
    - Dr Amortization Expense 30,000
    - Cr Accumulated Amortization 30,000
7. **IFRS Revaluation of Patent**:
    - Patent fair value increases to $350,000 by December 31, 2025.
    - Revaluation gain = $350,000 - $300,000 = $50,000
    - **Journal Entry**:
    - Dr Patent 50,000
    - Cr Revaluation Surplus (OCI) 50,000
    - **Amortization of Patent (IFRS)**:
        - Adjusted carrying amount = $350,000
        - Annual amortization = $350,000 ÷ remaining 9 years = $38,889 (approx.)
    - Dr Amortization Expense 38,889
    - Cr Accumulated Amortization 38,889
8. **Consolidation Notes**:
    - **US GAAP**: Goodwill is tested annually for impairment at the reporting unit level; no revaluation of the patent is allowed.
    - **IFRS**: Goodwill is tested annually at the cash-generating unit level; the patent revaluation increases equity via OCI.
    - Eliminate Sub Co.'s equity accounts (e.g., common stock, retained earnings) during consolidation under both standards.